Did the Tightwad Fed's Deflation Cause the Great Depression?

Robert P. Murphy, *The Politically Incorrect Guide to the Great Depression and the New Deal* (Washington, DC: Regnery Publishing, Inc., 2009), 63–80.

• Falling prices can be a sign of prosperity.
• There was sharper deflation in earlier depressions than in the 1930s.
• The Fed tried an "easy money" approach after the stock market crash.

In addition to the myth of the laissez-faire Herbert Hoover, another popular theory of the Great Depression blames the do-nothing Federal Reserve. Ironically, this interpretation comes, not from Big Government critics of the free market, but instead from none other than Milton Friedman and his monetarist followers. Just as modern-day Keynesians urge the government to "avoid the mistakes of Hoover" by running up massive deficits, so too do modern monetarists urge the Fed to "avoid the mistakes of the Depression" by injecting massive amounts of reserves into the banking system.

The parallels between the myth of the laissez-faire Hoover and the myth of the do-nothing Fed are striking. Just as Hoover engaged in unprecedented "stimulus" through his fiscal policies, so too did the Fed—starting immediately after the stock market crash in 1929—engage in unprecedented "easy money" policies. Because the massive budget deficits eventually forced Hoover to reverse course and raise taxes (in 1932), modern Keynesians say Hoover didn't borrow-and-spend *enough.* Similarly, because a gold outflow from the country eventually forced the Fed to reverse course and tighten the money supply (in late 1931), the monetarists say the Fed didn't inflate *enough.* But in both cases, the question remains: If budget deficits and cheap money were the right medicine, why was the Depression still getting worse, two years into these unprecedented fiscal and monetary remedies?

The reader surely knows that the myth of the do-nothing Hoover animates today's calls for Congress to spend more. But the reader may not be aware that the myth of the do-nothing Fed *also* motivates policymakers today. In fact, before assuming his current role as chairman of the Federal Reserve, then-Fed governor Ben Bernacke said in his 2002 birthday tribute to Milton Friedman: "Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: Regarding the Great Depression.You're right, we did it. We're very sorry. But thanks to you, we won't do it again."[1]

The myth of the do-nothing Fed is what has guided Ben Bernacke's response to the modern financial crisis. During the last three months of 2008, the Fed expanded bank reserves at an annualized rate of more than *400,000* percent.[2] (This—or anything remotely like it—has never happened before in the history of the Fed.) If Friedman's hypothesis is correct, then Bernacke's astronomical injections of liquidity are the right course of action. But if it turns out that Friedman was *wrong* to blame the Depression on deflation and the do-nothing Fed, then the United States economy may be on the verge of breaking some more records (and not good ones).

Friedman: The Timid Fed and Deflation in the 1930s

Milton Friedman and Anna Schwartz laid out their theory in their classic 1963 work, *A Monetary History of the United States.* Their argument was that the powerful Governor of the New York Federal Reserve Bank, Benjamin Strong, had been very competent as the de facto head of the entire Federal Reserve until his death in 1928. But after his departure, bureaucratic infighting and sheer incompetence led to disaster. Friedman gives a layman's summary in his (also classic) *Free to Choose:*

> [The] depressing effects of the stock market crash were strongly reinforced by the subsequent behavior of the Federal Reserve System. At the time of the crash, the New York Federal Reserve Bank, almost by conditioned reflex instilled during the Strong era, immediately acted on its own to cushion the shock by purchasing government securities, thereby adding to bank reserves. That enabled commercial banks to cushion the shock by providing additional loans to stock market firms and purchasing securities from them and others affected adversely by the crash. But strong *was* dead, and the Board wanted to establish its leadership. It moved rapidly to impose its discipline on [the] New York [Federal Reserve Bank], and New York yielded. Thereafter the System acted very differently than it had during earlier economic recessions

1. Ben Bernacke's remarks available at: http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021108/default.htm. (Accessed January 20, 2009.)
2. Bank reserve data maintained by the St. Louis Fed at: http://research.stlouisfed.org/fred2/categories/123. (Accessed February 2, 2009.)

> in the 1920s. Instead of actively expanding the money supply by more than the usual amount to offset the contraction, the System allowed the quantity of money to decline slowly throughout 1930. Compared to the decline of roughly one-third in the quantity of money from late 1930 to early 1933, the decline in the quantity of money up to October 1930 seems mild—a mere 2.6 percent. However, compared with past episodes, it was sizable. Indeed, it was a larger decline than had occurred during or preceding all but a few of the earlier recessions.[3]

To illustrate that this is not merely a technical debate that has been confined to professional economists, we note that historian and Cato Institute scholar Jim Powell endorsed the Friedman theory in his (excellent) popular book on the New Deal. After quoting Friedman and Schwartz's description of the Fed's rate hike in August 1929 to curb the speculative boom, Powell writes:

> The October 1929 stock crash made clear that the Fed had overplayed its hand…. Without realizing that one measure is having an effect not yet apparent, an anxious central banker could authorize another action that ended up compounding a problem and disrupting the entire economy.
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> These Federal Reserve policies began a monetary contraction. As the contraction became more severe, it brought on a depression in output, employment, and income. If nothing else had happened, there would have been a depression because of the severe monetary contraction.[4]

The problem with this explanation is that the Fed did try to inflate after the crash to rescue the economy, adopting unprecedented measures of "easy money" in 1930–1931, precisely when Powell (following Friedman) accuses the Fed of allowing a monetary contraction that yielded a depression. Moreover, the falling prices that correspond to a tighter money supply are not necessarily harmful to the economy.

The monetarists are right in laying much of the blame for the Great Depression on the Federal Reserve—but for the wrong reasons. The Fed's fault was *not* in providing too little liquidity; rather, its fault *was* flooding the credit markets in the 1920s, and then, after the stock market crash, in propping up unsound enterprises with even cheaper money. Economies recover from recessions or depressions by reallocating labor and capital to their most efficient uses. Propping up ailing industries only delays that necessary process and thereby deepens the weaknesses of an economy and delays recovery. The printing press does not create wealth; it creates green pieces of paper featuring U.S. presidents. The contraction of the early 1930s was the economy's attempt to recuperate from the earlier *bubble* inflated by the Fed—the proper role for the authorities at this late stage was to stay out of it, not to embark on another spree of dollar-printing.

Who's Afraid of Falling Prices?

We've all—wrongly—been trained to fear falling prices, now known as *deflation.* (Just as with the term *inflation,* the definition has morphed over time; originally *deflation* referred to a shrinking money supply, which of course tended to reduce prices.) In fact, many Americans have come to identify the very term *depression* to include "falling prices," rather than simply, "a very severe recession in economic activity," because one thing we remember about the Great Depression is that prices fell. It's not surprising, then, that Americans believe the talking heads on CNBC, when they warn of the evils of deflation, and recommend that the Federal Reserve flood the markets with new money just to be on the safe side. Peter Bernstein recalls the great deflation scare of the early 2000s:

> This [dot-com] recession, mild as it may have been, brought the economy perilously close to slipping into deflation. In early 2002, the CPI [Consumer Price Index] was crawling along at annual rates close to 1%, compared with more than 3% a year earlier. Greenspan and the Open Market Committee agreed that deflation would be the worst possible outcome, as Japan's disastrous experience in the 1980s had demonstrated so dramatically. Once consumers and business managers begin to anticipate lower prices, they postpone their purchases as long as they can—a decision that only makes the price declines even steeper and more difficult to reverse.[5]

We focus here on Bernstein's remarks not to single him out for criticism,but because he has so succinctly captured the dominant view of deflation, which is quite simply nonsensical.

For starters, notice that Bernstein's actual argument is that the problem with deflation is that it leads to …

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3. Milton Friedman, *Free to Choose: A Personal Statement* (New York: Harcourt Books, 1990), 79–80.
4. Jim Powell, *FDR's Folly: How Roosevelt and His New Deal Prolonged the Great Depression* (New York: Three Rivers Press, 2003), 29–30.
5. Peter Bernstein, from the Introduction to Milton Friedman and Anna Schwartz, *The Great Contraction: 1929–1933* (Princeton: Princeton University Press, 2008 [1963]), xxx.

more deflation. But unless we first know *why* deflation is bad, that is hardly a strike against it. Heroin use leads to more heroin use, and that is presumably a noble practice. If the reader finds our point to be flippant, consider this: Bernstein (echoing Greenspan) wants inflation. But after twisting a few knobs on Bernstein's warning,we can say with just as much validity: "Once consumers and business managers begin to anticipate *higher* prices, they *accelerate* their purchases as *quickly* as they can—a decision that only makes the price *hikes* even steeper and more difficult to reverse." If Bernstein has demonstrated the black hole of deflation, we have just demonstrated the supernova of inflation.

Bernstein could give the obvious response that deflation is worse than inflation because it's better to have people spending than hoarding. After all, businesses can't sell their products or keep people employed if everybody is holding out for bigger price cuts. But this (typical) argument proves too much. One could construct an analogous argument for the computer industry, in which the government passes regulation to slow down improvements in operating systems and processor speed. After all, how can computer manufacturers possibly remain viable if consumers are always waiting for a faster model to become available? What consumer would be foolish enough to spend money on a laptop when it will be obsolete in six months? The solution to this paradox, of course, is that consumers *do* decide to bite the bullet and buy a computer, knowing full well that they would be able to buy the same performance for less money, if they were willing to wait. This truism does't paralyze computer buyers, because if consistently followed the rule would never allow a person to buy a computer at all. The "deflation" that has always characterized the personal computer industry—that is, ever stronger computers getting ever cheaper to buy—is a sign of its health, not an explanation for its sickness.

But for the sake of argument, let us grant that falling prices cause many consumers to delay buying big-ticket items. This still does not prove that business sales in general will suffer. Suppose a man had planned on buying a new car for $20,000, but the local car dealership has bought far too much inventory and the man expects his desired car will sell for $19,000 in three months. It is certainly worth it for the man to wait 90 days and ear, in essence, $1000 for his patience. But it is even more lucrative for him to wait 90 days and earn $1,250, by reaping the $1,000 from the falling car price, but also using the three-month window to earn $250 in interest but putting his $20,000 into bank CDs yielding a 5 percent annual return.

As this example illustrates, falling prices don't encourage hoarding per se, they rather encourage *saving.* Many analysts who are terrified of deflation stress that in an environment of falling prices, cash stuffed under the mattress earns a positive return. This observation is certainly true, but nonetheless cash lent out earns an even greater return. Falling prices, then, encourage consumers to devote more of their income to savings, which in turn lowers interest rates and allows businesses to borrow and invest more. In effect, by postponing their big-ticket purchases, consumers free up resources so that businesses can buy more of *their* big-ticket items (a new copier, a new warehouse, and so on). One might wonder why businesses would borrow and invest if consumers are not spending on products, but we point again to the personal computer industry: if the price declines are expected to last, then at some point consumers will begin buying again. (There's no point in holding out for lower prices but never actually buying!) On the other hand, if the price declines are considered temporary, then consumers will begin buying again once they hit bottom. In either case, the mere fact of deflation doesn't paralyze business investment; consumers are buying fewer products today so that they can buy more products down the road.

There is one final argument for the alleged evils of deflation that we can quickly dispatch. The claim runs like this: in a deflationary environment, production comes to a standstill because profits get squeezed out of existence. After all, businesses make profits by buying the materials they need to produce their products and then selling the finished goods at a markup. But with falling prices, the producer's margin gets eliminated, turning a profit to a loss. So rather than tying up capital in a process that loses money, businesses will choose to earn a positive "real" return by sitting on their cash.

The problem here is that the argument mixes apples and oranges. Even if the prices of both raw materials and finished goods are constantly falling, producers can still make a profit so long as their materials are cheaper today than what the *finished goods* will fetch at the time of sale. Suppose over the course of five years, prices fall by half. In the year 2009, a bottle of wine (aged 5 years) sells for $40, while the total price for grapes and everything else needed to make a bottle of the wine is $10. Even though all prices will be cut in half by 2014, it still pays to spend $10 in 2009 buying the grapes in order to have a 5-year-old bottle of wine ready to sell for $20 in 2014. It's true that the price of the raw materials will have fallen to $5 by 2014, but that's irrelevant—you buy the grapes in order to make *wine,* not to sell the grapes after sitting on them for five years. The wine producer's original $10 investment still yields him a profit of $10 a bottle, even though we chose the numbers to reflect consistent and large deflation. By itself, in an otherwise healthy economy, deflation should be no more disruptive than inflation.

Deflation: Historical Evidence

During the heyday of the classical gold standard in the nineteenth century, industrialized countries often experienced periods of prosperity that went hand-in-hand with falling prices. In fact, there was consistent deflation in the United States for several years *before* the stock market crash. In 1926, consumer prices fell 2.2 percent, in 1927 they fell another 1.1 percent, and in 1928 they fell yet another 1.2 percent.[6] Falling prices spread the wealth in a more efficient way than Barack Obama's heavy hand of government possibly can. For example, Henry Ford's Model T sold for $600 in 1912 but its price had fallen to $240 by the mid-1920s,[7] putting car ownership within the reach of many more Americans, whose take-home incomes were growing rapidly thanks to increased productivity and lower tax rates. To hear some modern analysts discuss deflation, one would think the 1926 to 1928 period should have been awful for business. Yet this obviously wasn't the case.

Even the deflation following the 1929 crash wasn't the worst on record. From November 1929 to November 1930, prices fell 5.2 percent. Then from November 1930 to November 1931, they fell an additional 10.4 percent, and then a further 10.2 percent through November 1932. (Prices finally hit bottom in March 1933 and soon after began rising.) These are sobering figures, to be sure. But let us once again contrast the Great Depression experience with the earlier 1920–1921 depression. From their peak in June 1920, prices fell 15.8 percent over the next twelve months, a one-year deflation tht was 50 percent more severe than any 12-month fall during the Great Depression. And yet, the 1920–1921 depression was so short-lived that most Americans today are unaware of its existence.

Those terrified of deflation might play one last card: "True, the one-year fall in 1920–1921 was steeper than anything in the 1930s, but it was over before people's expectations really changed. The severe and persistent deflation in the early 1930s was what really sealed the doom on the American economy."

Well, actually, no. History tells us otherwise. Between 1839 and 1843 the money supply fell by 34 percent and wholesale prices fell by 42 percent.[8] If the monetarists are right, and it was the Fed's refusal to counteract the falling money supply in the early 1930s that gave us the Great Depression, then the 1839–1843 period should have been devastating. Yet Murray Rothbard (relying on Peter Temin's historical research) reports otherwise:

> [T]he effects on real production of the two deflations were very different. Whereas in 1929–1933, real gross investment fell catastrophically by 91 percent, real consumption by 19 percent, and real GNP by 30 percent; in 1839–1843, investment fell by 23 percent, but real consumption *increased* by 21 percent and real GNP by 16 percent.[9]

One shouldn't make too much of such comparisons, because the integrity of macroeconomic data becomes more suspect the farther back we look. Even so, it is safe to say that the deflation (whether defined as a fall in the money supply or a fall in prices) of the early 1930s, though severe, was not unprecedented in American history—and yet the economy suffered far more in the 1930s. The logical conclusion is that deflation and tight money supply were not the problem—or at least not the primary problem—during the Great Depression. To understand the causes of this most awful period in U.S. economic history, we need to look elsewhere.

But Why Would the Fed Destroy Money?

Casual readers who stumble across the monetarist explanation may draw the false conclusion that the Fed consciously sucked one-third of the dollars out of the economy after the stock market crash, in which case it seems a no-brainer that "the Fed's deflation caused the Depression." However, that is not what happened. Rather, the Fed tried unprecedented measures to bolster the financial sector, but its efforts were overwhelmed by the public's behavior, which, naturally, was to hoard money. The resulting decline in the money stock was therefore a tidal wave that the Fed could not contain, as opposed to a conscious policy decision by the Fed.The

6. Annual deflation figures calculated as the January-over-January changes in monthly CPI, available at the St. Louis Fed: http://research.stlouisfed.org/fred2/series/CPIAUCNS?cid=9.
7. Gene Smiley, *Rethinking the Great Depression* (Chicago: Ivan R. Dee, 2002), 6.
8. Murray Rothbard, *A History of Money and Banking in the United States: The Colonial Era to World War II* (Auburn, AL: The Ludwig von Mises Institute, 2002), 103.
9. Ibid.

Federal Reserve authorities actually don't have the power to determine the total amount of money in the economy, because of the fractional reserve banking system.

Under this system, the banks are legally required to keep only a small percentage (say, 10 percent) of their customers' cash deposits as a reserve to "back" the total checking deposits. Ignoring some complications, this means that if the banks have $50 billion collectively in their vaults as cash, then the total money supply in the economy is actually closer to $500 billion, because most merchants accept checks (or debit card transactions) drawn on commercial banks just as easily as they accept currency. In a fractional reserve banking system, the $50 billion in actual printed currency can do the work of $500 billion in pushing up prices in the economy.

This inflationary multiplier is reversed during a panic, when depositors withdraw their funds from checking accounts in order to have more liquid currency on hand. For example, if a depositor becomes spooked—perhaps he fears a bank run—and withdraws his entire checking balance of $1,000 to hold as physical currency, then his action will ultimately *destroy* $9,000 worth of money in the economy. Because the man reduced his bank's cash reserves (in the vault) by $1,000, the bank must reduce its total outstanding checking deposits by $10,000. It can accomplish this through nonrenewal of short-term loans, and by leaning on borrowers to repay their funds to the bank. But in any case, the man's decision to withdraw has reduced the total money supply in the community by $9,000, which will lead to a fall in prices (other things constant).

This is why monetarists assert that the Fed didn't do enough in the early 1930s to counteract the deflationary side-effects from scared depositors withdrawing funds. Yet it is ironic to accuse the Fed of doing too little to fight deflation, when it flooded the system with very cheap money, to an extent it had never done before in previous economic downturns.

Propping up Losers

To modern readers, it seems natural that during a financial panic, the Fed would adopt a loose policy. However, at the time of the stock market crash this effort to "provide a soft landing" to troubled firms was a new and improved medicine for an ailing financial sector—just as President Hoover was busy implementing his own revolutionary remedies. As opposed to the Fed's innovative easy-money approach to depression in the 1930s, the traditional remedy was summed up by Walter Bagehot's famous dictum for the Bank of Enland in the late 19th century: In a crisis, discount freely *but at a high rate of discount.*[10] In other words: the central bank should be prepared to loan as much as businesses wish to borrow, but only if they can put up good collateral and only if they are willing to pay a steep price.

This classical tough-love policy forced businessmen to be honest with themselves. If a firm were fundamentally sound but temporarily illiquid, it would be eligible for central bank loans and would be willing to pay the high interest rate on them. On the other hand, the people running firms that had no long-term future would realize the jig was up, and they would declare bankruptcy. This would cause temporary pain, to be sure, especially for the workers employed at these unprofitable businesses. But when the economy falls into a recession, it means that too many resources and workers are employed in the *wrong* places. Unpleasant as it is, the best way to deal with the problem is a quick and severe burst of business failures, to release assets and labor to other, profitable firms.

This traditional central bank medicine worked fairly well, inasmuch as American history students don't study any catastrophic worldwide depressions occurring in the nineteenth century. By now the reader will not be surprised to learn that during the *Great* Depression, the Fed and other central banks decided to try a kinder, gentler approach rather than the stern liquidationist strategy of the past. Writing in 1934, economist Lionel Robbins noted:

> In the present depression we have changed all that. We eschew the sharp purge. We prefer the lingering disease. Everywhere, in the money market, in the commodity markets and in the broad field of company finance and public indebtedness, the efforts of Central Banks and Governments have been directed to propping up bad business positions.
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> We can see this most vividly in the sphere of Central Banking policy. The moment the boom broke in 1929, the Central Banks of the world, acting obviously in concert, set to work to create a condition of easy money, quite out of relation to the general conditions of the money market. This policy was backed up by

10. See Ronald McKinnon, "Bagehot's Lessons for the Fed," *Wall Street Journal,* April 25, 2008, page A15, available at: http://online.wsj.com/article/SB120908336730343529.html. (Accessed January 23, 2009.)

> vigorous purchases of securities in the open market in the United States of America. From October 1929 to December 1930 no less than $410 million was pumped in the market in this way. The result was as might have been expected. The process of liquidation was arrested. New loans were floated.[11]

Robbins' description may surprise readers who are familiar with the monetarist explanation of the Great Depression. Nonetheless, the facts show that the Fed adopted an easy-money policy after the stock market crash. Various authors use different proxies for assessing Fed policy, and at this early period the very term "Fed policy" is a bit of a misnomer because the individual Reserve Banks enjoyed far more autonomy than they do today. In the interest of picking a straightforward and consistent measure, for our purposes we will rely on the discount rate charged by the Federal Reserve Bank of New York.[12] (The discount rate is the interest rate that the Fed charges on loans it makes directly to banks, which put up some of their assets as collateral.) When it opened for business in November 1914, the (New York) Fed set its discount rate at 6 percent. From that starting point, the Fed's discount rate varied, but never strayed below 3 percent.

In 1927, Great Britain was experiencing an alarming drain on its gold reserves, because it had pegged the British pound to gold at the pre-war parity, even though it had printed too much money during the war for this to be feasible. In order t take the pressure off the pound, the Fed lowered rates in 1927, which had the effect of increasing the supply of dollars and halted the outflow of gold from Britain. But this move fueled the stock market bubble, and the alarmed New York Fed began raising rates again in February 1928, reaching 6 percent by October 1929.

On November 1, 1929, just three days after Wall Street's Black Tuesday, the Fed slashed its discount rate by a full percentage point. Then fifteen days later it cut again, to 4 1/2 percent. Throughout the following year, it cut five more times, so that by December 1930 the New York Fed's discount rate had fallen to 2 percent. This was already a record-low for the Fed, but it cut further still, reaching 1 1/2 percent in May 1931 The Fed only reversed course and began hiking rates in October 1931, after Great Britain (the month before) abandoned the gold standard and Federal Reserve authorities needed to staunch an outflow of gold from the country by panicked world investors.

So we see that immediately following the stock market crash, the Fed began flooding the market with liquidity and in fact brought its rates down *to record lows.* Of course, those who blame the Fed for providing insufficient liquidity may say of these cuts, "too little, too late." But there's a problem with this: If the ostensible *cause* of the Great Depression—the one factor that set it apart from all previous depressions—was the Fed's unwillingness to provide sufficient liquidity, then how could it possibly be that the Fed's *record* rate cuts proved inadequate to solve "the problem"?

This is a crucial point, so let us restate it: Those who argue that the Fed's stinginess turned a typical depression into the Great Depression would have a plausible case if (say) the Fed cut rates after the crash in 1929, but only modestly, and not nearly to the same degree as it had cut rates during previous crises. If those were the facts, *then* it might make sense to argue that the Fed's lack of aggressiveness allowed the depression to fester into the Great one. But those *aren't* the facts; the Fed cuts after the stock market crash in 1929 through September 1931 were not modest, they wer at the time the most aggressive in its history.

Now perhaps there is more to the story than simple rate cuts. For example, some economists, following the monetarist explanation, have blamed the Fed for crowding out private efforts to rescue the banking system. In other words, before the Fed opened its doors in 1914, it was customary in a financial panic for private financiers and clearinghouses to coordinate and give assistance to solvent but illiquid banks, which were under pressure from customer withdrawals. Yet these private-sector solutions were hindered after the creation of the mighty Federal Reserve, as these liquid private groups held back and "waited forlornly for the rescue that never came."[13]

Although it is undeniable that the creation of the Fed paralyzed private-sector "lender of last resort" efforts, this factor by itself doesn't really explain the Great Depression. To see why, we draw from our old workhorse, the 1920–1921 depression—a severe contraction that occurred when the Fed had been "on the job" for six years. If the unprecedented rate cuts in the early 1930s were insufficient help to the banks because the Fed had scared away private-sector relief efforts, then the Fed's harsh rate *hike* in 1920–1921—which we are about to

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11. Lionel Robbins, *The Great Depression* (Auburn, AL: The Ludwig von Mises Institute, 2007 [1934]), 73.
12. Historical NY Fed discount rate data available at: http://fraser.stlouisfed.org/publications/bms/issue/61/download/132/section12.pdf. (Accessed February 1, 2009.)
13. Economists Thomas E. Hall and J. David Ferguson, quoted in Jim Powell, *FDR's Folly: How Roosevelt and His New Deal Prolonged the Great Depression* (New York: Three Rivers Press, 2003), 37.

describe—should have proved catastrophic, since the Fed's presence should have also crippled private-sector rescues during this period.

The expansion of the money supply during World War I had led to unconscionable consumer price inflation,which was running at more than 20 percent by late 1919. Consequently, the (New York) Fed hiked its discount rate from 4.75 percent up to 6 percent in one fell swoop in January 1920. The Fed then hiked again to a record-high 7 percent in June 1920. Despite the fairly severe depression—recall that unemployment averaged 11.7 percent in 1921—the Fed held steady to its record-high rate for almost a full year, not cutting until May 1921, after the depression was basically over.

Thus, surveying the entire period from its founding in 1914 through 1931, the New York Federal Reserve Bank's record-high discount rate occurred only during the 1920–1921 depression, and its record-low discount rate occurred only during the 1929–1931 collapse. (In other words, there were no other years in this period that had a rate as high as 7 percent or as low as 1 1/2 percent.) If the "insufficient liquidity" explanation for the 1930s Depression is correct, then the Fed's merciless behavior in 1920–1921 should have spawned a much greater depression, making the 1920s a decade of extreme misery. This is especially true when we consider that the price deflation in 1920–1921 was more extreme than in the early 1930s, so that the "real" interest rate was even more amplified. But as we know, the 1920s were arguably the most prosperous decade in U.S. history.

Really the monetarist explanation is backwards. Tightening the money supply—and other austerity measures, such as cutting government spending—may intensify the short-term pain, but by speeding the liquidation process they hasten the transition to a true recovery. The way out of our current economic slump is not bailouts, trillion dollar "stimulus packages," and Fed handouts of zero-interest-rate loans. These feel-good measures don't provide the proverbial soft landing, but instead prevent the market economy from healing itself.

Milton Friedman and Anna Schwartz's *A Monetary History of the United States* documents the bureaucratic infighting and at times shocking incompetence of the human beings who were running the Federal Reserve during the late 1920s and early 1930s. Their justly praised work is a welcome antidote to the all-too-common tendency to assume that "the authorities" know what they are doing, and that if a new government agency is created to Fix Problem X (such as deflationary bank panics), then that agency can only improve upon what the private sector accomplishes. Notwithstanding its contributions, however, their work created a myth, namely that the Federal Reserve sat idly back and allowed the economy to implode. That myth—like the myth that Herbert Hoover sat idly back and watched the Depression unfold—is continuing to drive misguided policies today.

How Could Milton Friedman Have Been So Wrong?

Milton Friedman was a gifted economist, and often right, but his famous monetarist explanation of the Great Depression is dead wrong. In previous depressions, the United States had experienced severer deflation and collapses in the money supply *without* suffering the economic devastation of the Great Depression. More problematic still for Friedman's theory, the Fed hiked rates to record highs during the 1920–1921 depression, while the Fed cut rates to record lows during the early 1930s. So how cold Friedman end up attributing the intensity of the Great Depression to a tightwad Fed?

The most immediate answer is that Friedman (and co-author Anna Schwartz) built their case on other evidence, and did not directly confront the challenges posed above. For example, Friedman could correctly point to incipient recessions during the 1920s that were nipped in the bud with Fed rate cuts. The stock market crashed after the Fed repeatedly *hiked* rates in 1928 and 1929, and so Friedman naturally concluded that low rates successfully kept depression at bay, whereas the foolish rate hikes invited disaster.

Another major argument for the Friedman camp was the apparent connection between recovery from the Great Depression and the abandonment of the gold standard. Often countries severed their currencies' ties to gold earlier than the United States, and they pulled out of the Depression more quickly. Focusing just on the American experience,the major economic indicators all turned around—at least temporarily—almost the moment Roosevelt took office and broke the dollar's tie to gold.

Although Friedman's arguments are superficially plausible, they miss the "big picture," which is that the

Fed's rate cuts in the mid-1920s weren't wise policy, but rather kept the price of capital too low—lower than free market rates would have been—and thus fueled a boom that had to go bust at some point. By the same token, the Fed's rate hikes late in the decade didn't push down the stock market, but instead stopped inflating it. When the Fed stopped pumping in so much cheap credit, the stock market naturally fell back to a more natural level.

The rapid infusion of new money following the abandonment of the gold standard may have given a temporary appearance of prosperity, but it certainly did not solve the world's economic troubles, which lingered through the Second World War. After the worldwide credit bubble had popped in 1929, the major economies *should* have experienced a severe depression while resources were shuffled into more appropriate and sustainable lines. The gold standard kept central banks honest, and allowed falling prices to signal the bleak news to everyone in the market that too many assets were overpriced. By leaving gold and flooding the world with paper money, the central banks weren't fixing the underlying economic problems, but instead only masking them. The result, as they say, is history. After all of the central banks abandoned gold and flooded their economies with new money—just as Friedman recommended—the world still suffered through many years of economic stagnation.

Books You're Not Supposed to Read:

The Ethics of Money Production, Jorg Guido Hulsmann (Auburn, AL: The Ludwig von Mises Institute, 2008)

A Monetary History of the United States, Milton Friedman and Anna Schwartz (Princeton, NJ: Princeton University Press, 1963)

Less Than Zero: The Case for a Falling Prie Level in a Growing Economy, George Selgin (London: Institute of Economic Affairs, 1997)